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E.O. 12958: DECL: 07/25/2015
TAGS: [ECON](#) [EPET](#) [EINV](#)
SUBJECT: UPDATE ON OPERATIONS OF OXY'S FORMER BLOCK

REF: A. QUITO 1216
[1](#)B. QUITO 1612

Classified By: EconOff Sara Ainsworth, for reasons 1.4 (b&d)

[1](#)1. (C) Summary: Occidental Petroleum (Oxy) cleared its first legal hurdle July 13 when the International Centre for Settlement of Investment Disputes (ICSID) officially registered its case against the Government of Ecuador (GOE). More than two months after the GOE declared caducity (reftel A), state oil company Petroecuador has managed to stay afloat by cobbling together an "independent" administration unit run by former Oxy manager Carlos Blum, pressuring service providers to continue their work on Block 15, and selling more than 3 million barrels of crude at a discount of as much as \$5 a barrel. Production likely continues to decline absent the use of Oxy's proprietary production management software, experienced technicians, or an operating and investment budget. End summary.

ICSID Will Hear the Case

[1](#)2. (SBU) Oxy's Senior Counsel Dan Almaguer told EconOff that ICSID officially registered its case against the GOE on July 13, after a strong push back from the court on jurisdictional concerns. The registration implies that the ICSID determined that Oxy's case meets the necessary conditions to be heard by the court. The GOE had argued that the case was an Ecuadorian domestic issue and therefore should be heard by an Ecuadorian court. Oxy presented two requests for arbitration on May 17, one by its exploration and production arm against Petroecuador for breach of contract, and the other on behalf of Occidental Petroleum Corporation against the GOE for violating the US-Ecuador Bilateral Investment Treaty. Almaguer expects to spend the first several months debating jurisdictional and procedural issues. The longer it takes to get the case in process, the more damage will be done to Ecuador's investment climate, which will limit the GOE's ability to sell the block. (Comment: Oxy has said they will include any operator that agrees to manage Block 15 in the arbitration proceeding. End comment.)

[1](#)3. (U) Under the rules of the ICSID, each side must first choose an arbiter, and then both must agree on a third. Oxy has chosen their arbiter, New Zealander David A. R. Williams, an international law expert who has participated on Oxy panels in the past. Ecuador has not yet chosen an arbiter and thus far has refused to publicly acknowledge the registration of the case at the ICSID.

Service Providers Continue Under Duress

¶4. (SBU) Several industry contacts have told us that service providers are working with Petroecuador in spite of concerns about the state entity's creditworthiness. Almaguer told us that service providers like Schlumberger and Baker-Hughes have "no choice" but to continue. He said that he had heard that Petroecuador already owed Schlumberger more than \$40 million, and that Petroecuador threatened that Schlumberger would be low on the repayment totem pole if it refused to work for Petroecuador. Under Oxy, Block 15 was Schlumberger's most lucrative contract, and therefore the company likely views continued work under Petroecuador a more economically viable option than pulling out of Ecuador.

¶5. (SBU) Baker-Hughes told EconOff that it is less beholden to Petroecuador than is Schlumberger. While Schlumberger rented its equipment to Oxy, (meaning its assets are 10,000 feet "in the hole"), Baker sold its machinery and therefore has no fixed assets in the ground. Since Oxy's caducity, Baker refused to work with Petroecuador until the state firm subrogated Oxy's contract. Earlier this month, Baker secured the same payment and liability terms that they previously had with Oxy.

¶6. (SBU) While Oxy paid all outstanding debts to its service providers, Petroecuador's payment history is another story. Baker told us that Petroecuador's outstanding payment cycle for the past year was more than 230 days on average. Another firm's representative told us that he heard one of Petroecuador's wire transfers to a service provider bounced. Rene Ortiz, President of the Hydrocarbons Industry Association of Ecuador (AIHE), estimated that Petroecuador owes service providers more than \$220 million, and postulated that eventually those companies would leave Ecuador for more lucrative contracts elsewhere.

¶7. (SBU) Even if service providers were willing to continue working with Petroecuador, they likely would be constrained by Petroecuador's lack of resources for drilling new wells. Oxy had three drilling rigs and a workover rig scheduled, all of which were removed from Ecuador after caducity. Petroproduccion (Petroecuador's production arm) Vice-President Jaime Crow told the press that it plans to contract two rigs to drill six new wells before the end of the year, however government regulations would first require approval from Petroecuador's senior board and an open bidding process. While Oxy had planned to drill fourteen new wells this year, Petroproduccion has failed to contract a rig in the last five years and is unlikely to engage one now given its financial situation and worldwide demand.

Petroecuador Pushing Production Under Limitations

¶8. (SBU) Oxy's operations at Block 15 were extremely "hi-tech", and Petroecuador has been operating the fields manually without Oxy's proprietary software for more than two months. The high water content in the reservoirs makes manual operation more difficult and pressure problems that can blow a well more likely.

¶9. (SBU) Though likely declining, reliable production figures for Block 15 have been difficult to calculate. Publicly, Petroecuador claims to be down only a few thousand barrels per day (bpd). Industry insiders have told us, however, that Petroecuador has lowered its projected shipments from Block 15 via the private OCP pipeline by 5,000 bpd. Oxy shipped only 75% of its production through the OCP, and industry contacts tell us there is tangible evidence that Petroecuador may be reducing normal shipments via the state-owned SOTE pipeline to conceal production declines. Some industry experts postulate that Petroecuador has stopped shipping crude via the SOTE altogether, implying a production decline of about 30%. The overall quality of blended crude in the SOTE pipeline has recently increased, suggesting that

less heavy crude from Block 15 is flowing through the pipeline. Although storage facilities onsite and at export terminals prohibit a precise calculation, Petroecuador may be using excess capacity via the SOTE to mask a potential production decline.

¶10. (C) Oxy representatives told us that Schlumberger representatives said that Petroproduccion has been over-producing the wells at Block 15 to maximize production. Based on this increased production pace, Almaguer suggested an increase of about 3,000-4,000 bpd, which also could mask production declines from shut-in wells or equipment failures.

¶11. (SBU) One industry representative told us that one of Oxy's generators was down, which would pose a major headache for Petroecuador. Almaguer told us that a failed generator in the western part of the field would be fairly inconsequential, because all well pads have individual generators, and that the area only yields about 25% of total production. The eastern side, specifically the Eden-Yuturi field, would be a more serious problem. Aside from the logistical problems involved with trucking in a new generator, the central generating facility houses five to six generators that power all the well pads, and would require rationing electricity if one failed. Petroecuador would have to selectively shut-in wells, a technical and time-consuming process. All the pumps on the block are electrical, and every drop of oil from the block requires electricity.

Management in Disarray

¶12. (SBU) Petroecuador appointed former Oxy manager Carlos Blum to head an independent management unit designed to run Block 15; however, the GOE still controls Petroproduccion's budget, subjecting it to the same corporate contracting rules and red tape. After nearly two months, the GOE lacks a strategic plan and separate budget for running the fields. Oxy had planned to invest nearly \$300 million into Block 15, something Petroecuador cannot hope to match. Petroecuador, for example, received only \$9 million of a requested \$30 million for operational expenses in June.

¶13. (SBU) Despite Blum's appointment, GOE officials are engaged in a public jostle for control over management of Block 15. Crow reportedly wants to retain several high level employees in key positions throughout the company, while Blum has proposed several former Oxy technicians for the jobs. Minister of Energy Ivan Rodriguez plays a role in decisionmaking at the block and managed the negotiations with Venezuela (reftel B). Petroecuador's board has failed to replace the company's president and is reportedly bickering about two candidates.

Venezuelan Failure Precipitates Discount Crude Sale

¶14. (C) Petroecuador tendered 3 million barrels of crude in June at a \$3-5 per barrel discount, translating to a loss of at least \$9 million in revenues. Several industry contacts speculated that GOE officials may be receiving kickbacks to sell crude at a discount. After negotiating more than a month with Venezuela, Ecuador failed to solidify a refining deal with Venezuela's state energy company PDVSA. Energy contacts told us that the deal was never technically viable for Venezuela and provided no economic benefit for Ecuador. Ecuador is now searching for a buyer to sign an eight-month export contract for 17 million barrels of crude from Block

¶15. Many oil companies are unwilling to enter contracts of one to two years, however, given the pending arbitration with Oxy.

Comment

¶15. (C) Ecuador's fiscal sustainability rests on the ability of an inefficient company (septel) without a real budget to

manage Block 15 and keep production at 100,000 bpd. Petroecuador lacks the technical capacity and capital to manage Block 15 the way Oxy did, and most industry experts agree that production is on the decline. The GOE's preference to work with state-owned energy companies is likely to imply less revenue for the country, but may succeed in lining the pockets of a few well-placed individuals. Even indigenous communities that helped push out Oxy have begun protesting for the company's return after Petroecuador has refused to honor Oxy's commitments for infrastructure and other community projects. End comment.

BROWN